

EPFSF Briefing: Consolidated Supervision

Summary.

- The art of Consolidated Supervision is to balance the consideration of the group as a single economic entity (across which risks can be diversified and/or concentrated) and the consideration of the group as a set of separate legal entities.
- There may be different perspectives on whether a group can be treated entirely as a single entity, and whether solo supervision should continue; it is worth noting that regulators license individual legal entities, not groups, and these individual regulated entities remain their primary focus. Not all of a group's supervisors will necessarily be based in the same Member State, nor even within the EU. Hence home/host issues are of crucial importance when assessing the needs and effectiveness of Consolidated Supervision.

1. Consolidated Supervision: What is it? To whom does it apply? How has it evolved?

Consolidated Supervision seeks to understand the risk of a group that contains authorised financial entities. Being part of a group means for a bank, investment firm or insurance company that this may have positive as well as possibly negative repercussions on the entities. Therefore group level supervision needs to be incorporated in the supervisory process. In general membership of a wider group is often seen as a source of strength for a regulated firm, for example because the group diversifies risks, or central risk management functions constitute an additional control-process.

At present the rules for Consolidated Supervision are sectorally based and do not overlap. They are governed by the Capital Requirements Directive (CRD) for banks and investment firm groups; and the Insurance Groups Directive (IGD) for insurance groups. For banking and investment firm groups, in most cases supervision includes a group capital adequacy requirement, in addition to that on a single entity basis. Under IGD insurance groups are simply required to perform a group capital calculation, with further supervisory action possible if the group does not pass the test. The Financial Groups Directive (FGD) covers the supplementary supervision of banking/insurance conglomerates.

Before Consolidated Supervision, requirements on capital adequacy, concentration risk and systems and controls were applied on an individual firm ("solo") basis. Regulators have been strengthening the rules for many years, but post-BCCI consolidated supervision was reinforced as a supplement to solo supervision, and to improve an overview of the group. It is not a substitute for solo supervision, although for the largest groups it plays a central role in how they are supervised. The complexity of some firms can lead to challenges for the group and for their supervisors.

2. Why has Consolidated Supervision not supplanted solo supervision?

Consolidated Supervision is seen as essential to avoid double gearing (i.e. ensure that capital is not double counted and used to support more than one entity in the group). But since one of the main objectives of supervision is to protect depositors/investors/policyholders, many supervisors think the only effective way to protect depositors in their Member State is to constrain groups to regulate capital adequacy on a solo basis. This "ring-fencing of capital" guards against the possibility that, should a regulated entity fail, the group would be unable for legal or other reasons to move capital to the weakened/failing entity, which could damage depositors, investors, or policy holders and might also damage market confidence or even have adverse systemic effects. The Basel 2 Accord was drafted on both a consolidated and solo basis, and this concept is mirrored in the CRD. Solvency II project, as described in section 4

goes one step further in consolidated supervision and in trying to align supervision with how groups are managed today.

Thus Consolidated Supervision has not, to date, been seen as a full substitute for solo supervision and the directives still apply largely on a legal entity level. However, this structure does not reflect how many groups manage their activities increasingly on a business line basis, which may bear little or no relation to the legal entity structure of the group. Capital, liquidity and risk management may be central functions that support the entire group, so that it can benefit from better and more consistent risk control. The directives are starting to recognise this aspect: e.g. under the CRD the consolidating supervisor will require a group-wide "Pillar 2" assessment, and the local supervisor has a good deal of discretion to rely on this group-wide assessment, or may apply the requirement for a firm to manage its capital at the national sub group, depending on the specific circumstances of that firm in its jurisdiction. Not surprisingly some – especially the largest - firms would prefer it to apply *only* at group level.

3. Supervisory cooperation in Consolidated Supervision

A group will have at least as many supervisors as the number of countries in which it has a regulated entity. This puts an intense premium on cooperation and coordination between the supervisors. Failure to coordinate effectively can and does lead to duplicative, overlapping and burdensome requirements for some firms. Also, it may lead to a failure to avoid or at least mitigate systemic effects in other Member States caused through the collapse of a European banking group.

The EU legislative framework seeks to remove barriers between supervisors, and further steps are needed to remove barriers between regulators. Within the Single Market the Home/Host relationship seems mostly well understood, demarcated in the directives, and supported by supervisory cooperation in the Level 3 Committees. Under CRD Article 129 regulators must cooperate on information exchange, supervisory activities and validating group internal models, and the consolidating supervisor has the authority to take the final decision on the validation of a group model if a joint decision cannot be reached. Article 129 will be subject to a review of its functioning. Although legislative basis are calling for a cooperative approach, much needs to be done to further improve efficiency and effectiveness in this process.

4. The next model for Consolidated Supervision?

Solvency II makes a step change towards treating an insurance group as single economic entity. It therefore strikes an appropriate balance between a view of an insurance group as a single economic entity across which risks are pooled and diversified, and another view of an insurance group as a collection of legal entities.. This is a major current debate. This move is seen by many as favourable to greater efficiency in the insurance sector and the international competitiveness of insurance groups in the EU.

Recognising the group as a single economic entity results from a policy decision to incorporate diversification effects into group capital requirements. Diversification is fundamental to value creation in the insurance sector, and so to providing economically efficient protection for policyholders. Yet this decision also affects the balance of responsibilities between the supervisors of the group and of its separate companies. A clear allocation of roles is essential. Insurance groups must meet the same standards of policyholder protection as individual firms, and supervisory cooperation needs to reinforce this.

There have been many discussions in recent years in the financial services sector on whether the framework set up by the CRD is appropriate or rather whether it should be changed. In addition to addressing the legitimate concerns of those responsible for protecting depositors' money and of internationally-active groups, any EU supervisory structure must also guarantee a level playing field between local entities and subsidiaries/branches of internationally-active groups.

One model for consolidated supervision of cross-border groups which has received the attention of both the financial industry and the European institutions is the lead supervisor concept. This concept recognises the economic reality of business organisation and foresees a clear division of tasks between supervisors. The lead supervisor, who is the home supervisor of the parent company, would chair a college of supervisors from the different Member States where the group is active. The college would be the forum where all involved supervisors share information and where the decisions to be taken by the lead supervisor on matters of prudential supervision can be discussed. A mediation mechanism would be available for any disagreements between the supervisors.

5. Conglomerates Supervision: a next step?

Although there are debates on the extent to which Consolidated Supervision can replace solo supervision, extending supervision to span the different financial sectors introduces different demands as the assessment of capital and of risks differs between the sectors. However, groups with interests in both insurance and banking/investment sectors are not new, and some are very large. In fact most of the largest banks in the EU are conglomerates. Supervisory consideration of these groups was introduced in the Financial Groups Directive (FGD), also known as Financial Conglomerates Directive (FCD). Since 2005 it has applied "supplementary supervision" to conglomerates at least 40% of whose business is financial, with at least 10% or €6 billion in each of the insurance and combined banking/investment sectors.

Supplementary supervision includes a capital adequacy test (where the capital for the conglomerate must equal at least the sum of the individual sectoral requirements), setting out a range of methods to eliminate double counting of capital and excessive leveraging. It also requires conglomerates to have adequate systems and controls to monitor (but not limit) exposures between group members and risk concentrations across sectors.

FGD was particularly significant for Consolidated Supervision as it introduced a single supervisory coordinator for each conglomerate, with defined obligations, including group supervisory oversight, information exchange and cooperation; but this is a supplementary role, as the capital and solvency of the banking and insurance businesses within the conglomerate continue to be governed by the CRD and IGD provisions. On the other hand this is the model that the CRD built on and expanded in Article 129, and which Solvency II may extend further.

The FGD introduces supplementary supervision of conglomerates, on top of the sectoral prudential supervision under the CRD and the IGD/Solvency II. If a change of the current regime is desired, the review of the FGD in 2008 should aim to replace (part of) the sectoral supervision by conglomerates supervision or at least to ensure there is sufficient consistency between the sectoral approaches to issues such as definition of capital (the Commission mandated CEBS and CEIOPS to examine this issue) and methods of consolidation.

6. International Competitiveness

Consolidated Supervision and Conglomerate Supervision are founded on valid supervisory concerns. But as with all aspects of prudential regulation, there is a need not to constrain international competitiveness. EU Group supervision needs to be reflected at international level by adequate co-operation with third countries through and mutual recognition of both prudential supervision and requirements on the Solvency II basis as many large firms operate globally beyond the EU boundaries. FGD sets out a process to assess if non-EEA conglomerates operating in the EEA are subject to equivalent supervision in their home country, and, if not, advocates appropriate oversight or alternative measures.

7. Consolidated Supervision – the right balance?

In conclusion, the obligation of supervisors to protect their domestic markets must be balanced not only with the supervision of financial groups that are structured to reflect the international nature of their business in furtherance of competition but also the unification and consolidation of the financial market place in Europe.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

Chair Administrative Committee
Guido Ravoet, EBF
Rue Montoyer 10, B-1000 Brussels
Tel: 0032 2 508.37.25
E-mail: G.Ravoet@ebf-fbe.eu

Secretariat
Francesca Mollica, EPFSF Secretariat
Av. de la Joyeuse Entrée, 1-5, B – 1040 Brussels
Tel: 0032 2 504 80 40/ Fax: 0032 2 504 80 50
E-mail: fmollica@epfsf.org

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